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SUBJECT: Commerzbank Announces Third Quarter Write-Offs

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¶1. Summary. The release of third quarter earnings reports has shed further light on the extent of the damage caused by subprime investments in the German banking industry, with Commerzbank, Germany's second largest private bank, reporting larger write-offs than originally anticipated. While Commerzbank and its competitors continue to generate earnings from traditional sources that more than offset their write-offs, this wave of losses shows that the burden of subprime debt will continue to weigh on banks' balance sheets. As mortgage-backed securities no longer yield high returns, private banks will have to develop new investment strategies to replace this once-lucrative vehicle. Meanwhile the European Central Bank (ECB) announced that it would roll over two supplementary longer term refinancing operations issued at the height of the crisis into the new year, as an ongoing part of its efforts to bring stability to the still fragile interbank lending process. End Summary.

Third Quarter Reports: It's Not Over

¶2. On November 6, Commerzbank AG, Germany's second largest private bank after Deutsche Bank, released its third quarter earnings report which revealed a rise in total profits of 56%, based mainly in the traditional sectors of tax gains and private banking. Despite the overall positive trend, the report also revealed larger than expected write downs of 291 million euros (\$425 million) in investments based in U.S. mortgage-backed securities. Commerzbank's losses were not nearly as high as those of Germany's largest bank, Deutsche Bank. Deutsche Bank, which invested more aggressively in subprime vehicles, wrote off losses of 2.16 billion euros (\$3.17 billion). Deutsche Bank also reported overall profits in the third quarter.

¶3. Commerzbank CEO Klaus-Peter Mueller had braced investors for the news as early as October 20 admitting to a "further market impact" from subprime loans and opining that there would be "repercussions" when banks released third-quarter earnings reports. The reports of write-offs from Commerzbank and Deutsche Bank showed that the German banking sector would clearly weather the storm, but the large private banks days of record-setting profits were in the past in the near term.

Klaus-Peter Mueller: Voice of Caution

¶4. Like many other large banks, Commerzbank stepped in early when the subprime crisis began in August to stave off insolvencies and

calm panic. On August 22, when reports started coming out that two small German banks, SachsenLB and Deutsche Industriebank (IKB), were facing insolvency, Commerzbank made three billion euros (\$4.38 billion) available on the interbank market to stabilize the German banking sector. Joining Deutsche Bank's CEO Josef Ackermann and others in trying to calm investor fears, Mueller said in a September 5 statement that he saw the market stabilizing, adding "There are good reasons to believe that the markets will return to calm waters."

¶5. Commerzbank initially appeared to be better protected from the crisis than its competitors. On September 20, Mueller announced the bank would set aside a relatively small 92 million euros (\$128 million) to cover an estimated 80 million euros (\$111.2 million) in subprime losses, although he admitted that Commerzbank had no way of knowing what a "sufficient" figure to cover the losses would be. Deutsche Bank announced comparatively larger potential losses of 1.5 billion euros (\$2.1 billion) in late September.

¶6. While Deutsche Bank CEO Josef Ackermann continued to go on the record to assure investors that the crisis was not a major worry, Mueller adopted a more cautious stance, saying that Commerzbank was largely protected but it was not clear where other banks stood. A Commerzbank executive told EMIN and Congen Econoff on October 11 that, while Commerzbank had over 10 billion euros in conduits, the conduits were mostly originated by Commerzbank and of good quality (see reftel a). Mueller remarked privately to Frankfurt Consul General November 2 that the worst was yet to come, and expressed dismay that U.S. television was still running advertisements for cheap mortgages.

¶7. In a long anticipated move, Mueller also announced October 22 that he will step down as CEO of Commerzbank on May 15, 2008 to become Chairman of the Executive Board. He will be replaced by Martin Blessing, a current board member.

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The ECB: A New Kind of Normalcy

¶7. The reports of losses have fueled the crisis of confidence in the German and greater European banking sectors, necessitating further action by the ECB. On November 8, the ECB announced in a press release that it would roll over two supplementary longer-term refinancing operations (LTROs) valued at 40 and 75 billion euros that were set to mature at the end of November and the beginning of December. The two LTROs had been issued in late August and early September at the height of the credit crunch.

¶8. In another sign of fragile banking conditions, the spread between unsecured three-month interbank lending and the risk-free equivalent remains at fifty-one basis points, while it was in single digits in early August. An ECB executive told Congen Econoff November 13 that the distrust between banks shown in this disparity may be "a new kind of normalcy" reflecting a more accurate assessment of risk and that interbank rates may never return to the halcyon days of before.

¶9. Comment. When Blessing succeeds Mueller next year, he will inherit a bank that, like many banks in Europe, will need to find new sources of earnings. German banks such as Commerzbank have made record profits from a combination of high return mortgage-backed securities and other more traditional sources of income. Where banks will turn to replace the earnings from mortgage-backed securities is unknown, but profits in the near future may not be as high as before the subprime bust and a new type of normalcy where interbank lending is not as fluid may take hold. End Comment.

¶10. This cable has been coordinated with Embassy Berlin.
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